



HOW TO SELL A VETERINARY PRACTICE

Dr. Paul, age 50, owns a companion animal practice in a suburban community. While retirement is at least another ten to fifteen years away, he knows the value of advance planning. Four years ago, he began his plan for attaining financial security. Today, he is well on his way to reaching his goal by age 56. The value of his practice plays an important part in attaining this security and with his business plan in operation, the practice is on track for reaching his target value of \$900,000. Dr. Paul knows that the practice value he is building is only assured if he has a buyer willing and able to buy when he is ready to sell. As his financial security depends on getting full value for his practice, he knows his plans for ownership succession must be carefully thought out.

Who will buy my practice?

From personal research and talking with his practice advisors, Dr. Paul learns that his choice of potential buyers will likely be determined by the size of his practice. Buyers from outside of the practice will typically seek one-doctor practices or multiple-doctor practices with high revenue while mid-sized, multiple-doctor practices are usually sold to insiders – associate veterinarians in the practice.

Dr. Paul learns that in screening outside buyers for a one-doctor practice, the seller should first assess the buyer's ability to pay. This means:

- a. Obtaining a credit report, credit references – any and all credit documentation required by a commercial lender before making a loan.
- b. Securing an interest in all assets of the practice and having the right to review the practice records and financial reports periodically. When you finance the sale of your practice, you are assuming the role of banker. Be sure your sales document gives you all of the rights of a secured lender including the right to reacquire the practice if payments are not made.
- c. Requiring the buyer to maintain a life insurance policy with the proceeds payable to the seller. This ensures that the purchase price will be paid in full in the event of the buyer's death.

An issue that is often overlooked is the buyer's ability to own and manage a business. This issue is particularly critical when the seller finances the sale. A practice that is sold to a buyer with no experience in management or ownership can boomerang back to the seller and at a sharply reduced value.

Finally, leaving succession unresolved places the seller at the mercy of the market. Will there be a buyer for the practice when the seller is ready to sell?



When selling to a privately or publicly held corporate buyer, a seller must also first assess the buyer's ability to pay. The seller should not presume that the buyer is financially sound. Dr. Paul has heard that many corporate acquisitions are structured in part for cash with the balance paid in the buyer's stock and/or notes. If this is the alternative he chooses, his advisors will assess the payment terms. For example:

- a. If a portion of the payment is to be made in the stock of the acquirer, what is the volatility of the share price? If the company is publicly traded, what is the investment outlook? Is there a required holding period, or can the shares be sold at any time?
- b. If a note payable is part of the purchase agreement, the seller will be assuming the position of lender. Are the financing terms reasonable? Will market rate interest be paid on the outstanding balance? Is the note secured? What is its position relative to other corporate debt? For example, if the sale proceeds include a subordinate note, the interest and principal payments on the note will be paid after other creditors and other note holders have been satisfied.
- c. If ownership of the real estate is retained, will a fair market rent be paid? What are the seller's options if the new owner decides to move the practice after the lease expires?

Any below-market payments whether in rent, veterinary compensation, management compensation, interest on debt, etc. reduces the true selling price of the practice and therefore, the total dollars received.

Finally, leaving succession unresolved places the seller at the mercy of the market when it's time to sell.

Will there be a corporate buyer for the practice? As Dr. Paul's practice is a mid-sized, three-doctor practice, he looks closely at the advantages of selling to one or both of his employed veterinarians:

- a. An owner can sell a part interest to an associate today and ensure receiving full value for the balance in a future sale by executing a buy/sell agreement. This agreement typically requires remaining shareholders to purchase a departing owner's interest in the event of death, disability, or retirement. The purchase is made at the fair market value at the time of the subsequent sale.
- b. The owner can directly observe the buyer's abilities in management and ownership before the final sale takes place.



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For Dr. Paul, controlling the timing of the sale is of utmost importance. He decides his best option is to plan for an inside sale to one or both of his associates, Dr. Robins and Dr. Green.

Dr. Paul previously sold a part interest in his practice to an associate and learned several valuable lessons in the process:

Lesson #1: Employment longevity is not an indicator of ownership ability. Four years ago, Dr. Paul sold a 25 percent interest to a long-term associate with the intent of sharing management and ownership responsibilities. Unfortunately, his new owner did not have the interest or the ability to manage. It was a lesson learned the hard way. The associate could have happily remained long-term with the practice to the benefit of all parties. Instead, the attempt at ownership strained the relationship among the doctors and staff, and the new owner decided it was best to sell his shares back to Dr. Paul and move on to another practice.

Lesson #2: An associate is not automatically “endowed” with management knowledge when he or she become a practice owner, nor is “jumping in the deep end” the ideal way to learn. Dr. Paul has already involved one of his associates, Dr. Robins, in medical management (decisions regarding the future of medical services and the equipment, training, etc. needed to reach the practice’s medical goals).

At this point, Dr. Paul knows that Dr. Robins has the interest and ability to be a practice owner. As Dr. Paul will eventually leave the practice and finance the sale of his remaining interest, having experienced management in place is critical.

Dr. Paul believes that when selling a practice of his size, it’s best to secure two buyers. If ownership is offered to Dr. Green and declined, how will that affect his long-term plans?

Dr. Paul wants to resolve this issue within the next two years. That way, if Dr. Green doesn’t buy in, Dr. Paul will have sufficient time to bring in an associate who has the ability and interest in ownership. By starting his succession planning now, Dr. Paul is giving himself plenty of time to secure his buyers and keep his plan on course.

How should I structure the sale?

Dr. Paul has been told that how the sale is structured significantly affects the dollars he ultimately receives. Dr. Paul wants to structure the sale in a way that will be fair to all parties and wants to understand the issues and alternatives. His practice is structured as a C Corporation.



Issue #1: What is being sold, corporate stock or assets and liabilities?

Dr. Paul learns that buyers usually prefer to buy assets and liabilities rather than stock. This enables them to select which assets they will purchase and which liabilities they will assume. Buying assets also allows the buyer to claim depreciation (a tax-deductible expense) on all depreciable assets such as medical equipment, office equipment, and goodwill. If the buyer purchases stock, the buyer acquires *all* assets and liabilities owned by the corporation, but without the benefit of reporting a depreciation expense on the tangible assets or the goodwill.

Sellers usually prefer to sell stock. All gain on the sale is taxed as a capital gain. However, if individual assets and liabilities are sold, part of the gain, for example, the recapture of depreciation previously claimed on tangible assets, the value of accounts receivable, the value of inventory, etc., will likely be taxed as ordinary income.

Dr. Paul decides that the corporation will not be dissolved and therefore stock, rather than assets and liabilities, will be sold.

Issue #2: Who is the seller, Dr. Paul or the corporation?

If Dr. Paul is the seller, he will pay capital gains tax on his gain – the difference between his selling price and his tax basis. The buyer's tax basis for future sales will equal the amount paid.

If the corporation is the seller, there is no taxable gain or loss on the sale. The buyer's tax basis will again equal the amount paid. If Dr. Paul wants to take the cash out of the corporation, however, a tax liability will be incurred. If the cash is paid to him as a dividend, it will be taxed to him as ordinary income and will not be tax deductible by the corporation. Also, dividends are paid pro rata, which means that the new owners will share in the distribution according to their percent of ownership. If Dr. Paul receives the cash as compensation, it will be taxed to him just like any other compensation he receives from the practice—as ordinary income. The expense will be tax deductible by the corporation only if there are profits to offset it.

Although Dr. Paul's tax basis is quite low, he decides to sell his shares, pay the tax, and invest his proceeds outside of the practice.

Issue #3: Can the sale be structured to make the purchase more "affordable" for the buyer?

The buyers will likely use all or a portion of their owners' return on investment, *after taxes*, to make their payments. Can this tax be avoided? His advisors tell him that the buyer's tax cost can be reduced if he sells the practice for less. This would occur if operating expenses were increased. For example, can Dr. Paul as the practice's landlord increase the rent and still stay within the range of fair market rent? Increasing practice expenses reduces Dr. Paul's selling price. In exchange, he receives additional rental income. Is this acceptable to the buyer and the seller? If Dr. Paul agrees,



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he will be agreeing to an increase in his tax liability. He will be replacing capital gains with ordinary income – a significant increase in his tax liability!

Dr. Paul decides that the selling price will not be changed and tax liability will be paid as incurred. Will his buyers understand that they will be in the same “after tax” position in buying his stock as they would if buying stock in any other investment? In addition, they will be receiving a substantial return on their investment to help cover their payments.

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